

Chazen International Study Tour Report

Egypt and the United Arab Emirates: State-Sponsored Capitalism as a Barrier to Innovation

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Chazen International Study Tours

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Introduction

Over the last decade, even in the last weeks and months, the MENA (Middle East North Africa) region has witnessed significant change, both in the composition of its economic infrastructure and in the level of interest it has garnered from global social, economic, and political circles. Yet, a popular misconception that the Middle East can be viewed as a singular entity still lingers. There is no “one” Middle East; indeed, it is comprised of diverse countries with unique culture and customs, and equally distinct financial markets and political challenges. As was made clear by this year’s Chazen trip to Egypt and the United Arab Emirates (UAE), to create excessive parallels between these two countries would be imprudent.

And yet, even as we must treat these countries in very different ways, they are both countries in which state-sponsored capitalism has reigned supreme and in which, consequently, innovation and entrepreneurship has had little room to develop. Indeed the subject of innovation and entrepreneurship came up in nearly every meeting and in many conversations of 2011’s Chazen trip to the region. If the degree to which they were the focus of conversation is any indicator, students and businesses alike believe both innovation and entrepreneurship are required for the existence of a strong, vibrant, and sustainable economy.

Executive Summary

The focus of this paper is to understand the drivers of innovation and entrepreneurship in the Middle East. What are Egypt and the United Arab Emirates (with a focus on Abu Dhabi and Dubai) doing well? What do they need to improve in order to develop these traits? Our resources are conversations gleaned from some of each country’s leading private and government-run offices, professors at Columbia Business School, and information from selected reading – which includes, among others, articles from the *Economist*, *McKinsey Quarterly*, and the *Financial Times*.

We begin with an introduction to, and overview of, the region. We next examine the three broad characteristics that emerged as the primary drivers of innovation and entrepreneurship in the region. Finally we examine the extent to which any or all of these drivers is present in first Egypt and then the United Arab Emirates.

In light of unrest in Tunisia, Lebanon, Jordan, and Egypt, the future of the MENA region is, at present, unclear. However, we firmly believe that innovation and entrepreneurship are essential to the long-term socio-economic prosperity of the region. As such, we hope that as

regimes change and reform, they continue to foster human capital, financial capital, and open regulatory environments.

The Middle East – not “one” face:

On the face, Egypt and the United Arab Emirates look like very different countries. This is indicative of the region as a whole: while many think of there being “one” Middle East, the region is host to surprising diversity.

Egypt is home to the largest population in the MENA region, with 83 million inhabitants across nearly one million square kilometers of territory, only 5 percent of which is inhabited and cultivated.ⁱ The UAE has approximately 5.6 million inhabitants across its 77,700 square kilometers (excluding islands).ⁱⁱ Population differences like this are not uncommon in the region: Saudi Arabia has a mid-sized Arabic population, with almost 27 million citizens, whereas the population of Bahrain here is “smaller than many Parisian neighborhoods” at 1 million.ⁱⁱⁱ

While the gross domestic product for Egypt and the UAE is not wildly different – just under \$200 billion for the former and approximately \$250 billion for the latter – gross domestic product per head differs wildly, coming in at approximately \$2,400 in Egypt vs. \$38,200 in the UAE.^{iv}

Egypt has a history going back to ancient times, whereas Dubai’s earliest settlement goes back to 1799 and the population numbered as little as 40,000 in 1960. Professor Suresh Sundaresan, a Columbia Business School professor and an expert on global emerging markets, points out the ironic juxtaposition that the two nations find themselves caught in: Egypt, home to one of the world’s wealthiest and most technologically-advanced ancient civilizations now finds itself stagnated economically, politically, and socially – while one of the Middle East’s more recently developed civilizations, the UAE, is known internationally for its progressive nature and applauded for the creativity and excess of its “golden city,” Dubai.

Indeed, leading economists, such as Philippe Dauba-Pantanacce at Standard Chartered Bank, view the MENA region as having three distinct subsets, no doubt as a result of these strong statistical, economical, and historical differences:

- 1) **Gulf Countries (with a history of British occupation):** Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Oman, and Bahrain; Yemen is currently not included in this category.
- 2) **Levant Countries:** Syria, Lebanon, Jordan, Palestine and other occupied territories.

- 3) **North African countries (with a history of French occupation):** Algeria, Tunisia, Morocco, Libya, and Egypt. These countries tend to resemble Northern Europe in political structure and policy.

Abdalla El Ebiary, a Managing Director at Citadel Capital, one of Egypt's top private equity firms with over \$8 billion in AUM, states that the MENA region can be viewed as one "target market," as are the 50 United States. However, he cautions against underestimating the vast social, political, and economic differences that exist within and among each region. Just as one would segment the United States regionally to understand the influencers of socio-economic characteristics, one must also segment the Middle East.

Indeed, regional differences are even present in different Arabic dialects spoken in each region. Egyptian Arabic being the most widely understood dialect as a result of Cairo's status as the "Hollywood" of the Middle East. "Everyone has seen Egyptian movies," noted Dauba-Pantanacce.

The Middle East – a home for state-sponsored capitalism:

For the reasons stated above, the MENA region must be examined as having surprisingly deep variety. Understanding this, we can now begin to examine the ways in which Egypt and the UAE are similar. Both are predominantly Muslim countries where the state, for reasons outside the scope of this paper, dominates. As such, capitalism in both countries is state-sponsored.

The state-sponsored capitalism in both countries leads to a few similar characteristics. First, both economies are relatively diversified. Egypt's economy is comprised of manufacturing, mining and petroleum, agriculture, and tourism to name a few, with no one sector dominating more than 17 percent of GDP.^v While the UAE broadly speaking is less diversified – oil revenue contributed to 59 percent of Abu Dhabi's GDP in 2005-2007 – Dubai has largely weaned itself away from oil and is reasonably diversified.^{vi} As of 2006, the biggest contribution came from wholesale and retail trade (34.6 percent), manufacturing (15.6 percent), real estate (15.2 percent), and the financial sector (9.3 percent).^{vii}

A second similarity is that both countries are seen as being relatively open to the west, likely due, in part, to the presence of large ports in both countries and the flow of Western capital through the economy due to tourism and financial investment.

A third similarity is that in many of our conversations in both countries, the local population viewed government jobs as extremely desirable. Egypt's Deputy Minister of Finance, Hany

Kadry Dimian, relayed an anecdote where one of his family members refused to look for work for years, living off of unemployment, until he was able to get a government job. In Dubai, Standard Chartered Bank's Dauba-Pantanacce mentioned that the public sector is "paid like New York City investment bankers." Anecdotally, cab drivers would speak enviously of the cushy lives of Emiratis: where the government built them houses, gave them jobs, and access to the best healthcare.

Because the state in both countries sponsors capitalism, it is seen as the driver of the welfare of its people.

And yet, because the government necessarily has an agenda and is often quite sizeable, it is often not able to facilitate innovation and entrepreneurship. According to Professor Sundaresan, "Key structural issues must be solved within governments" before entrepreneurship and innovation can flourish in the Middle East.

In the pages that follow we will examine what – through company visits and conversation – emerged as the primary drivers of innovation and entrepreneurship and how government might encourage both.

Requirements for Innovation & Entrepreneurship:

In response to a question about the presence of innovation in the region, Dauba-Pantanacce said: "Innovation happens in a certain environment – and that environment is not here."

Across conference rooms in both Egypt and Dubai, many reasons for this emerged: poor education, unclear financial rules, the will or training of the people, the government, etc. While the list goes on and on, three primary drivers that encompass these disparate ideas emerged:

- 1) Available Human Capital – The presence of a native population in possession of skill sets that are closely aligned with market demand. An adequate pool of human capital depends first on a sufficient and able native population and second on education.
- 2) Access to Financial Capital – The ability of capital to flow freely from investors or governments to companies and individuals, with minimal numbers of financial intermediaries.
- 3) Favorable Legal & Regulatory Environment – The extent to which the government and society facilitate and support innovators with clearly defined laws and regulations related to intellectual property, ownership rights, and the separation of individual and corporate entities for financial purposes. This includes clear and consistent financial reporting

standards, easy-to-understand and universally applied tax code, and patent and bankruptcy law.

Egypt: A Highly Political Transition Economy

Egypt's transition from a state-based to a more market-based economy has been a recent phenomenon, with the majority of progress taking place in the time since 1990, when Egypt implemented an economic Improvement program to encourage Foreign Direct Investment (FDI) and facilitate growth in GDP.^{viii} At present, Egypt's political and economic future is uncertain. What we are able to discuss usefully is what it was like prior to January and February's unrest, in the hopes that knowledge of the past will inform the future.

Egypt fares poorly when rated according to the three above-listed prerequisites for innovation and entrepreneurship. While its native population is sizable, young, and of improving literacy, it lacks the skills required by businesses and is often stymied by an effort to overcome the achievements of its ancient countrymen. Both corruption (at the government level) and lack of PE and VC funds (at the private capital level) prevent capital from flowing easily to nascent businesses or entrepreneurial individuals. Lastly, the regulatory environment and financial reporting standards have only recently started to improve.

Human Capital in Egypt

In reviewing several recent examples of nations that have moved from state-sponsored entrepreneurship to traditional entrepreneurship, the development suitable human capital is doubtless a recurrent theme. As we have witnessed in both India and China, the private sector cannot take over without human capital, and economic growth alone will not lift a population from poverty – it must be accompanied by increased job opportunities brought about by new businesses.^{ix}

Unfortunately, Egypt has not seen a growth in jobs or new businesses, likely owing to issues with basic education infrastructure that precludes its young population from ever entering the realm of entrepreneurship. Based on a survey conducted by the Journal of Private Equity in 2010, “there was a consensus between all PE/VC firms on the lack of entrepreneurs in the Egyptian market. All of them confirmed that an entrepreneurial culture cannot be promoted without continuous and regular instructions... Entrepreneurial skills must be taught through university programs.”^x As part of the same survey, a private equity manager in Egypt states, “We keep repeating deals with the people we trust. We are looking forward to making deals

with new entrants. To be honest, public community in Egypt suffers from lack of understanding of entrepreneurship and culture as a concept.”

Egypt has one of the first prerequisites of human capital: a large native population. Furthermore, the largest subsegment of its population of 83 million is youths aged 15-25^{xi}. Literacy has improved, with adult literacy at 66.4 percent and youth literacy at 87.4 percent in 2006, up from 44.4 percent and 63.3 percent in 1986 respectively.^{xii} 11.9 percent of government spending goes to education.

And yet, despite this investment, Egypt is subject to significant unemployment and a severe shortage of technically skilled workers, such as mechanics or carpenters. Every year, over 700,000 youth graduate from college in Egypt with hopes of obtaining a limited number of high-paying positions in the Egyptian government.^{xiii} Hany Kadry Dimian, Egypt’s Deputy Minister of Finance attributes this phenomenon to the country’s earliest roots, indicating that the grand reminders of Egypt’s past – its temples, pyramids, and papyrus scrolls – overwhelm the population and create the feeling that some jobs are simply “un-doable.”

Part of this can be attributed to an education system that fails to align taught skills with business’s needs: “Egyptian businessmen complain that a shortage of talented workers is one of the biggest obstacles to growth, second only to obstructive bureaucracy.”^{xiv} Egypt’s educational system emphasizes “nationalistic values, scientific formulas, and lists of facts, rather than critical thinking” and may also be partly to blame for Egypt’s lack of suitable human capital.^{xv} Minister Dimian appeared to agree with this postulate, stating, “Our government does not teach people to fish; it simply gives subsidies to keep the status quo; it does not encourage innovation and jobs, which will multiply capital invested.”

While top Western colleges and MBA programs have entire concentrations dedicated to the study of entrepreneurship, little formal education on the topic exists in Egypt. The Harvard Business Review supports this conclusion, indicating that, ““Of course, it doesn’t help that most of [MENA] citizens are used to being supported by the government and, until very recently, were not entirely familiar with the hurly-burly of entrepreneurship and global competition.”^{xvi}

Financial Capital in Egypt

It is no secret that entrepreneurs’ ability to access financial capital is a key ingredient in economic development and increased innovation. Academicians and practitioners alike have confirmed that in developed nations, the availability of growth capital “has led to thousands of new jobs, new expenditures for research and development, and increased export sales.”^{xvii}

Until the most recent revolt in Egypt, President Hosni Mubarak kept a “tight control on power and billions of dollars in U.S. aid flowing with few strings attached.”^{xviii} U.S. aid to Egypt fell to \$1.55 billion in 2010, down from \$2.1 billion in 1998, according to a Congressional Research Service report, making Egypt the second largest recipient of U.S. aid for most of the recent past. As such, Egypt’s issue hasn’t centered around access to capital but instead on its ability to allocate this capital directly to entrepreneurs; the majority of Egypt’s foreign aid has been channeled toward developing its military capabilities – not improving the social welfare of its population or funding growth in small enterprises.^{xix}

Through the course of the last fifteen years, though, Egypt has dramatically shifted its attitudes toward entrepreneurs and has taken definitive steps to increase the amount of growth capital available to them, specifically within Public and Private Equity markets.

Even amid sweeping reform and marked improvements, deal-makers and would-be entrepreneurs must still contend with many of Egypt’s deeply rooted social and political agendas as they pursue private equity funding agreements, and are forced to navigate complex “wink and nod” agreements made between political figures, businessmen, and implementers.

Because of the highly political business environment, Dr. Mohamed Radwan, Professor of Marketing at the American University in Cairo and a serial entrepreneur, notes, “not always does the best deal get done; not always does the best candidate get the deal.”

Politics also plays a role in entrepreneur’s access to funding, and “knowing the right people” is paramount, says Radwan. A recent article in *The Journal of Private Equity* states that Egyptian entrepreneurs “experience some difficulties attracting funding if they are not part of the social network of PE/VC firms,” owing to the limited information on PE/VC firms available online, the lack of understanding about early-stage investment among the public, and the absence of a formally regulated PE/VC market.^{xx}

Where public equity is concerned, a visit to the Egyptian Exchange (EGX) highlighted the nascence of a regulated equity exchange in the Egyptian economy. Liquidity in the market is still low given the lack of education around the role of public equity; businesses are reluctant to list on the exchange for fear of losing ownership and the public views equity as a passive long-term investment. That said, the Egyptian Stock Exchange is currently taking steps to improve public education and financial literacy and has seen increased trading volume from around the MENA region as a result of heightened reporting and transparency requirements for listed companies.

Improved education and regulation of Egypt's capital markets is paramount to the country's ability to sustain entrepreneurship. Increasing financial literacy and continuing to enforce ever-tightening regulations will likely have the effect of mitigating the unpredictability, volatility, and instability inherent of emerging capital markets, increase foreign and domestic investment in Egyptian businesses, promote more attractive terms for securing capital, and will ultimately have the effect of promoting a growing culture of entrepreneurship.

Regulatory Environment in Egypt

Sweeping political and regulatory reforms have taken place in Egypt over the last two decades. The 1990's saw improved oversight of the public equity markets, and the reopening of the Egyptian Stock Exchange (EGX) following closed doors of more than 30 years. Prior to its re-emergence in 1994 and the implementation of electronic trading and transaction recording, all trading was done based on a "gentleman's agreement" and recorded on a chalk board. While the response to improved technology, regulations, and transaction recording has been largely positive, one trader at the EGX noted, "there seem to be fewer gentlemen today [than there were 30 years ago]."

To further support access to capital and entrepreneurship in Egypt, the government has made great strides in reforms to tax law, corporate law, and corporate governance. In 2005, the Egyptian government lowered personal and corporate tax rates, reduced the administrative burden of incorporating a new company, and improved corporate governance and adherence to IFRS standards in an attempt to encourage industry and further improve Egypt's access to foreign investment. Underscoring improvements that support entrepreneurial pursuits, the Minister of Finance in Egypt noted that incorporating a company in Egypt took over 30 days in 2004 -- today the same process can be completed and approved in less than three days.

As the government continues to play an active role in enforcing legal and regulatory reforms, the Egyptian economy, "is performing better than ever, largely because the government has abandoned its old habits of ... state managed capital allocation, high taxes, and price controls."^{xxi} By maintaining oversight of corporate markets, reducing the time and money required for corporate administration, and effectively communicating changes to its regulatory environment to the public, Egypt will undoubtedly encourage investment in its public and private equity markets – providing more capital access and opportunity to its entrepreneurs.

United Arab Emirates: State-sponsored Capitalism & Citizenship Issues Inhibit Growth

The lack of innovation and entrepreneurship in the UAE differs wildly from Egypt and can be most attributed to the human capital and financial regulation drivers. The native Emirati population is not appropriately educated or of a sufficient size to drive innovation alone. Innovation and entrepreneurship could be imported, but under current laws, the ex-patriot population does not have the legal right to fill in this gap. In better news, some private enterprises such as Abraaj Capital are using private business to help standardize financial reporting, and thus points to a wave of the future.

Human Capital in the UAE

The problem of human capital can first be addressed by examining Dubai's Emirati population. By many accounts citizens get land from the state when they are married, have a house built by the state, and have water and power provided by the state. Whether it is through general standard of living or through public-sector jobs that pay better than private sector jobs (salaries of recent public sector employees were recently increased by 70 percent in order to combat inflation), the government takes care of its citizens.^{xxii} If the UAE wants to better develop innovation and entrepreneurship, it should reincentivize its workforce. It can also look to education to develop these traits.

World-class education is still developing, with many Western universities opening remote campuses in the UAE and the MENA region more broadly. However, according to AJ Singh, Associate Principal at McKinsey & Company's Middle East Offices, the educational infrastructure to support bottom-up (i.e. garage) innovation does not exist. What innovation there is in the UAE is top down (i.e. government-sponsored) and comes from leapfrogging western practices. In his presentation, Mr. Singh cited growth in the alternative energy sector and the Masdar project as evidence of this trend, further commenting: "This region must import talent from the West to support innovation."

In addition to the importation of western universities, Abu Dhabi has identified education as one of its primary goals in its 2030 plan. Education was a topic featured prominently in the study tour group's meeting with the Advanced Technology Investment Company (ATIC), a subsidiary of the Mubadala company, and – through training and scholarships – is one of the primary means to which ATIC is fulfilling Mubadala's double bottom-line requirement and hopefully driving innovation.

While education and a reexamination of government incentives could breed a more entrepreneurial and innovative Emirati culture, there remains a problem of scale. We defined human capital as being a native population in possession of skill sets that are closely aligned with market demand. By some estimates, the 1.9 million-person population of Dubai is 93 percent expatriate. Any back-of-the-envelope calculation will lead you to see that the UAE simply does not have a population large enough in number to drive innovation and entrepreneurship. Continuing with the trend of importing talent, one could argue that it would necessarily fall to expats to innovate, but they only enter the UAE when already employed and there is no path toward citizenship.

Regulatory Environment in Dubai

In order to allow talent and innovation to stick, the UAE must either address its paths to citizenships or change its business ownership requirements. In our meeting with McKinsey, Mr. Singh pointed out that one of the biggest differences between America and the UAE – as countries that foster innovation – is that America allows expatriate to create a home. Currently there is no path to citizenship in the UAE. Expats born in Dubai or Abu Dhabi are not and never will be citizens. People who work in the UAE – regardless of how long they work there – must return to their country of origin (or some other place) when they retire. Ideally the UAE would address this issue by offering a path to naturalization.

Another means to addressing this issue is through eliminating the requirement that all businesses operated outside designated free-zones must be at least 51 percent Emirati owned. Indeed, recent articles have mentioned that the UAE is considering making changes to these foreign ownership laws.^{xxiii}

While regulations involving expat participation in the economy are the most crucial to developing innovation and entrepreneurship, uniformly applied and used financial reporting standards are another important requirement for enabling small businesses to thrive. On this note, groups like Abraaj Capital, one of Dubai's oldest PE funds, have made a promising start with its SME Funds. In its Approach to The Stakeholder Society (January 2010), the company remarks: "Through this [SME Fund] initiative, we will invest hundreds of millions of dollars in SMEs across the MENA with the aim of creating high-impact, high-growth, successful businesses to fuel innovation, job-creation, sustainable growth, and economic diversification. At its core the platform will give enormous support to the indigenous entrepreneurship that exists

across the broader region and that can be unleashed regionally and globally, through leadership, capital, and nurturing by Abraaj.”

By acting as a group that helps foster SMEs, Abraaj – and likely other, similar PE funds – are demanding and hence perpetuating increased rigor in financial reporting and an emphasis on SME projects.

Conclusion

Despite their social, political, and economic differences, Egypt and the United Arab Emirates both struggle with a clearly defined lack of entrepreneurship and innovation, which is most likely due to the prevalent role of state-sponsored capitalism within each respective nation.

Until recently, government in both nations has functioned like a Band-Aid – providing financial, educational, and regulatory infrastructures that support the immediate needs of the people but fail to take into account the needs of future generations and the role of innovation and entrepreneurship in moving a population to the next phase of socioeconomic and political development. Put differently, by continuing to keep its people dependent on government subsidies and state-issued jobs, the government of both countries has, in effect, removed the financial incentives and cultural expectations necessary to promote innovation.

Building the entrepreneurial system at the grassroots levels with education reform, improving access to growth capital, and increasing government regulation of legal and financial systems will no doubt stimulate the entrepreneurial spirit in business communities across the nation. As we learned first-hand, the Middle East is filled with more than just oil. It is a land rich with talent, ambition, and capital and has the ability to be a keystone in the world’s financial system.

ⁱ Egypt Country Report, November 2010. The Economist Intelligence United Limited 2010. Chazen Packet.

ⁱⁱ UAE Country Report, November 2010. The Economist Intelligence United Limited 2010. Chazen Packet.

ⁱⁱⁱ Philippe Dauba-Pantanacce, Senior Economist at Standard Chartered Bank, presentation.

^{iv} Egypt Country Report, November 2010. The Economist Intelligence United Limited 2010. Chazen Packet.

^v *ibid*, p.8.

^{vi} Key Facts about Emirates Dubai and Abu Dhabi, February 28, 2009, dalje.com.

^{vii} *ibid*.

^{viii} An Explanatory Study of Private Equity and Venture Capital in an Emerging Economy: Evidence from Egypt. Abeer Hassan. The Journal of Private Equity. Spring 2010.

^{ix} Professor Suresh Sundaresan. Conversation. January 31, 2010.

^x An Explanatory Study of Private Equity and Venture Capital in an Emerging Economy: Evidence from Egypt. Abeer Hassan. The Journal of Private Equity. Spring 2010.

^{xi} The Economist: A special report on Egypt: July 17th 2010. A Slow Learning Curve, Chazen Packet.

^{xii} UNESCO Institute for Statistics. Statistics in Brief for Egypt.

^{xiii} Hany Kadry Dimian, Deputy Minister of Finance, presentation.

^{xiv} The Economist: A special report on Egypt: July 17th 2010. A Slow Learning Curve, Chazen Packet.

^{xv} The Economist A special report on Egypt: July 17th 2010. The Best Man Always Wins: How Egypt's Government Perpetrates Itself. Chazen Packet.

^{xvi} HBR: Where Oil Rich Nations are Placing Their Bets. Chazen Packet.

^{xvii} An Explanatory Study of Private Equity and Venture Capital in an Emerging Economy: Evidence from Egypt. Abeer Hassan. The Journal of Private Equity. Spring 2010.

^{xviii} Bloomberg.com "The Lobbyists Watching Egypt's Back." February 3, 2011. James Rowley.

^{xix} Professor Suresh Sundaresan. Conversation. January 31, 2010.

^{xx} An Explanatory Study of Private Equity and Venture Capital in an Emerging Economy: Evidence from Egypt. Abeer Hassan. The Journal of Private Equity. Spring 2010.

^{xxi} The Economist: A special report on Egypt: July 17th 2010. A Slow Learning Curve, Chazen Packet.

^{xxii} Conversation with a recent CBS alum working in the region.

^{xxiii} Morris, Martin. "UAE ponders change in foreign ownership rules – report." 14 September 2009. ArabianBusiness.com